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Supreme Court of the United States

OCTOBER TERM, 1929.

No. 226.

THOMAS A. EARLY, RECEIVER OF THE FARMERS & MERCHANTS NATIONAL BANK OF LAKE CITY,
PETITIONER,

versus

FEDERAL RESERVE BANK OF RICHMOND,
RESPONDENT.

ON CERTIORARI FROM THE U. S. CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF OF RESPONDENT.

M. G. WALLACE,
For Respondent.

(34,357)

THE WILLIAM BYRD PRESS, INC., RICHMOND, VA.

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OBJECT OF CONTRACT.

The essential facts of this case have been correctly stated by counsel for petitioner and are likewise stated in the opinion of the Circuit Court of Appeals, hence a repetition is unnecessary, but inasmuch as the case depends upon the

construction and application of a written contract made to regulate the dealings of the parties in a rather complicated series of transactions, we consider that a statement of the methods commonly used by banks in collecting checks is desirable in order to enable the court to determine the true intent of the parties in making this contract. The object of the contract was to prescribe a method for the handling of checks deposited by member banks with Federal Reserve banks, which checks were drawn upon other banks, and the terms of the contract describe the duties of the Federal Reserve bank and the rights and liabilities of the depositing banks and the rights and liabilities of the drawee or paying banks.

Checks are the instrumentalities by means of which almost all settlements and payments between persons who live in different parts of the country are effected. Every bank receives daily on deposit or for collection many checks drawn upon other banks in different places and sections of the country. Each of these checks must be presented to the bank upon which it is drawn, and if the check is good, payment must be made by the drawee bank to the collecting bank. The Negotiable Instrument Law defining the rights and duties of the parties to a check contemplates that the holder will through himself or his agent present the check at the counter of the drawee bank, and demand money, and surrender the check to the drawee only when the money is paid; but under working conditions it is impracticable for a collecting bank to send a special messenger to present each check which is deposited with it. Banks therefore usually send checks to correspondents in financial centers and these correspondents collect the checks from the drawees and credit the proceeds to the depositing bank. The balance thus created is used by the depositing bank to pay checks drawn upon itself. The following presents a practical illustration of an ordinary method of collecting a check before the inauguration of the Federal Reserve System:

A bank in Charleston received a check payable in Richmond. The Charleston Bank sent the check to some corre-

spondent in Richmond. This correspondent collected the amount from the drawee bank. The Richmond bank was then compelled to find some method of settling with the Charleston bank for the money which it had collected. To ship the money would be risky and expensive, but the Charleston bank probably had an account with some New York bank and carried a balance with this depositary, and the Richmond bank probably had a balance with the same or some other bank in New York. The Richmond bank therefore sent to the Charleston bank a draft payable in New York, which the Charleston bank in turn sent to its New York correspondent or depositary. This depositary collected the check from the New York bank on which it was drawn and credited the amount to the bank in Charleston. The result of this transaction was that money formerly on deposit to the credit of a Richmond bank was transferred to the credit of a Charleston bank. After that the Charleston bank could use this available balance in New York as a means of settling for checks which it was obliged to pay to persons in places other than Charleston.

The above illustration is a very simple one. If we attempted to trace the process of collecting a check deposited in a bank in a small village in South Carolina and payable in a small village in Virginia, several additional steps would be necessary, but the underlyng principle was always the same; that is to say, banks kept the greater portion of their available reserves on deposit with other banks in financial centers and used these reserve deposits as a means of paying checks which were presented by holders who did not live in the same city with the drawee bank; and maintained these reserve balances by depositing with their correspondents in reserve centers checks payable in different parts of the country. If every bank in the country had its reserve in the same center, or in certain designated centers, collection of checks would be greatly facilitated, for each bank could send to these central reserve depositaries checks drawn on every other bank in the country, and the checks could be collected by a simple method of clearing under which checks received

from any bank could be credited to its reserve account, and checks paid by any bank could be charged against its reserve account. Thus the reserve account of each bank could be maintained by its collections from other banks, and this reserve would always be available to pay checks drawn on the bank. Ordinarily the volume of checks deposited with the central clearing agency by any bank, and of checks on this bank presented through the central clearing agency would be approximately equal, but, if at any time the volume of checks on any bank should be unexpectedly large, it could pay these checks by remitting funds to the central reserve agency, or, if that agency had the power of lending, by borrowing from it. Apparently realizing that the maintenance of reserves, and the use of reserves, was inseparable from the collection and payment of checks, Congress in creating the Federal Reserve banks provided that each of them might be required to serve as a collecting or clearing agency for member banks, and provided that means by which collections and clearances between Federal Reserve banks could be made. Every Federal Reserve bank was required to receive on deposit any check upon any member bank, and thus as to member banks the Federal Reserve banks would operate much in the same manner as clearing houses; that is to say, each member bank could deposit with its Federal Reserve bank a check upon any other member bank and eventually receive credit for the amount of such check unless it was returned dishonored, and each member bank would be compelled to pay to the Federal Reserve bank checks drawn on it and deposited by other member banks unless such checks were returned protested.

In the Regulations promulgated and in the Circular three classes of banks are mentioned: (1) Member banks; (2) Non-member clearing banks; (3) Non-member remitting banks.

The first class comprises, of course, banks which are members of the Federal Reserve System and therefore must maintain a reserve on deposit with the Federal Reserve bank; the second class comprises non-member banks which maintain a deposit balance in the hands of the Federal Re-

serve banks and which therefore have, as far as check collection and clearing is concerned, the privileges of member banks; and the third class consists of non-member banks which have no reserve account on deposit with a Federal Reserve bank, but are willing to remit to it in a satisfactory way for checks which may be sent by the Federal Reserve bank to the non-member bank. Dealings with the last two classes of banks mentioned are in no way concerned in this suit. We merely mention them in order that the court may understand the references to the three classes in the Circular and in the Regulation.

As between member banks the exchange and collection of checks can be conducted upon principles essentially analogous to a clearing house; that is to say, every member bank can deposit every check which it receives upon any other member bank in the Federal Reserve bank and all checks received by the Federal Reserve bank upon any member can be sent to it and settlement can be made by the simple expedient of charging and crediting checks presented by one bank and accepted and cancelled by another.

In a city clearing house the operation of charging and crediting is simultaneous so that all members receive immediate credit for all checks drawn on other members placed in the clearing house and are charged with all checks drawn upon themselves presented through the clearing house, and, of course, if any check be returned unpaid, the bank returning it is credited and the bank depositing it is charged. When such operations are conducted at a daily meeting absolute assurance can usually be given that if a check be deposited in a clearing house it will either be returned to the depositor unpaid or else the money will be obtained from the drawee. When this system is extended to banks throughout a district, it is obvious that a check cannot be presented to the drawee on the same day that it is received at the clearing house; but time must be allowed for the check to be presented to the drawee, and returned if necessary, and for the drawee to restore its reserve if it were depleted by charging the check against it. The time allowance in the case of each

bank must of necessity vary in order that the more remote members may not be penalized by having checks charged against them before they have an opportunity to accept and pay the checks and charge them to the accounts of the drawers, and make transfers of funds to restore their reserve balances, if necessary.

The introduction of the time element, however, opens the operation of the district clearing house to one serious defect not inherent in the local clearing house. The drawee bank may cancel the checks drawn upon itself and may fail before it has met its clearing house debit, and therefore the drawee bank may at the time of its failure be a debtor in the clearing house, and other members who have deposited checks on it may be placed in the position where the drawer of the check is released and yet payment has not been obtained from the drawee bank.

Such cases as *Federal Reserve Bank* v. *Malloy,* 264 U. S. 160, 44 St. Ct. 296, and *Cleve* v. *Craven Chemical Company,* 18 Fed. (2nd) 711, and numerous other state and federal cases which have dealt with the liability of the parties when a check has been cancelled by the drawee but payment to the holder has not been made, show that the hardship suffered by the holder of a check in such an instance is very real, and the situation is a hotbed of litigation. If, for example, a merchant in one city accepts a check from a customer in another and forwards this check for collection through banking channels, the merchant may find that the operation necessary to collect this check in a convenient manner has resulted in the release of his customer who sent him his check, and the substitution of a claim against an insolvent bank in a remote place wholly unknown to the merchant. If this situation could be avoided, it would be a "consummation devoutly to be wished." It is not possible to devise a plan under which the situation will never occur, but a provision under which the reserve balance would always be applicable to the payment of any check cancelled and not returned reduces the danger to a minimum. Since one object of the check clearing system of the Federal Reserve

banks was to encourage the free use of checks upon member banks and to give to such checks currency in the business world by providing the best possible means for their collection there was every reason to endeavor to avoid any losses to the holders of checks deposited, if possible, for every holder who fails to obtain payment of a check which has been handled through the Federal Reserve banks naturally loses some confidence in the System.

The Federal courts have consistently held that ordinarily a collecting bank is obliged to present a check received on deposit to the drawee and demand payment in money, and is liable to its depositor if it does not obtain payment, or return the check unpaid with the liability of the drawers and endorsers preserved. The reason for the establishment of this rule appears to have been the realization of the danger which is unavoidable in any method of collection which involves a surrender of the check to the drawee before the amount is actually paid. A collecting bank may of course by special contract relieve itself of this liability, as the Federal Reserve banks have done; but in so doing it imposes the unavoidable risk on its depositor. It is apparent that, having done this, the collecting bank should seek to make such an arrangement as will reduce to a minimum the inevitable risk inherent in working conditions. The nearest possible approach to a presentation of the check to the drawee, and a surrender of the check only when payment is made, is a system under which the check is mailed to the drawee under an agreement authorizing the forwarding bank to charge it against funds of the drawee in the forwarding bank's hands unless the check is returned.

ARGUMENT ON PETITIONER'S POINT A.

In their argument under this point counsel for petitioner emphasized that the charge against the reserve balance of the Lake City bank was not to be made until the expiration of the transit time, i. e., three days. We have endeavored to show that this interval was allowed as a matter of neces-

sity because of the situation of the parties and the inability of one to learn of the actions of the other except by communicating in the ordinary course of mail. If the charge had been made earlier, in many cases the effect would be that the Lake City bank would be charged with checks which it had never accepted or paid, but which had been dishonored by it and returned protested. In addition, the Lake City bank could not foresee the amount of checks which would be presented on any day; hence if it were charged with the checks on the day upon which they were received and handled by it, its reserve would be apparently depleted and it would be penalized for a deficiency in reserve, even though it had immediately taken steps to restore its reserve by remittances or transfers sufficient to cover the amount of the checks. Under the rule laid down by this court in *McDonald* v. *Chemical National Bank*, 174 U. S. 610, title to remittances or transfers made by the Lake City bank would pass to the Federal Reserve bank on the day upon which such remittances and transcfers were made by the Lake City bank, even though the Federal Reserve bank was not advised of such remittances or transfers until later. Theoretically, therefore, it would probably be proper to charge the reserve account of the member bank with checks cancelled by it as of the date on which the checks were cancelled, and in computing reserves to credit the reserve account with shipments of currency or transfers as of the date upon which such shipments or transfers were made or directed, but it is obvious that under ordinary accounting system such a method of bookkeeping would be impracticable.

To hold that the necessary delay in adjusting the books, which was of necessity allowed in order to meet the practical conditions, constituted the extension of unsecured credit for checks which should have been immediately paid upon presentation, is to give a forced construction to a business agreement and is we submit to ignore utterly the plain provision:

"The right is reserved, however, to charge a cash

letter to the reserve account of a member bank at any time when in any particular case we deem it necessary to do so."

If this provision does not indicate a clear and positive intent to make the reserve balance of the member bank applicable to all checks not returned, we are unable to see that any meaning whatsoever can be assigned to this provision which was obviously inserted in the circular and regulation with the idea that it would create some definite right.

Counsel for petitioner appear to rest much of their argument upon the statement that the reserve balance was not a specific fund. We do not see how it can be said that a bank balance on deposit in a particular bank is not a specific fund. We do not see why a depositor may not agree that any sum which he has on deposit in any particular bank may be appropriated to obligations nominally due to that bank regardless of whether such obligations are due to the bank in its own right or as agent or trustee for others.

Counsel for petitioner lay great emphasis upon the statement that the drawee bank was allowed to draw against its balance during the transit period. Nothing in the record indicates that any such right on the part of the drawee was recognized by the Federal Reserve Bank. It is true that the account filed in evidence shows certain charges made after the dispatch of these letters and before a report upon them had been received, but it is extremely likely that such charges were made on account of letters previously dispatched or notes or other obligations of the drawee bank maturing and becoming chargeable in the regular order prior to the letters in question.

Since the Federal Reserve Bank could not during the transit period be aware of the disposition made of the checks, the Lake City bank might have succeeded in withdrawing its balance, leaving the checks unprotected, but the rights of the parties cannot be determined by the probability that one could have taken advantage of the other. That the Lake City bank, after cancelling the checks, could not have

compelled or required the payment of the balance seems too clear to require demonstration.

Assume that on the afternoon of October 9th the Cashier of the Lake City bank had called the Federal Reserve Bank and had demanded that currency to the amount of the apparent balance be shipped to the Lake City bank, would the Federal Reserve Bank have been compelled to ship this amount, or could it have replied that the balance would be held and credited as a payment on the letters of October 7th and 8th? We would be willing to rest this entire case upon the answer to this question, and it seems to us that to answer this question it is only necessary to read the plain and unambiguous words of the provision under which these checks were surrendered to the Lake City bank. If the Lake City bank could not have demanded and compelled payment of the balance on October 9th, the receiver could not do so, for it is elementary that the rights of the parties are determined by the status existing when insolvency intervenes, and the receiver can enforce only such right as the insolvent might have enforced at the moment of suspension.

In cases depending upon the construction of contracts it is always difficult to cite authorities which are exactly in point. The contracts under consideration are rarely identical, but in every case which we have examined in which a similar contract or arrangement has been considered the courts have held that the balance of the failing bank was applicable for the payment of such liabilities, even though the collecting bank acted only as agent.

The following cases will be found to be very similar to the case at bar:

Storing v. *First National Bank* (C. C. A. 8th), 28 Fed. (2nd) 587.

Federal Reserve Bank v. *First National Bank* (U. S. D. C.), 277 Fed. 300.

Midland National Bank and Trust Co. v. *First State Bank of Sioux Falls* (175 Minn. 555), 222 N. W. 274.

Farmers National Bank v. *Penn Bank*, 123 Pa. 283, 16 Atl. 761.

Penn Bank v. *Farmers National Bank*, 130 Pa. State 209, 20 Atl. 150. (Affirming case next above without opinion.)

The case of *Federal Reserve Bank* v. *First National Bank*, *supra*, and the unpublished decision in *Keyes, Receiver*, v. *Federal Reserve Bank*, which is printed as an appendix, deserve, we think, especial consideration, even though they are decisions of district courts, because these cases involve dealings of member banks with Federal Reserve banks and construe a Regulation of the Federal Reserve Board which on the particular point was substantially the same as the Regulation enforced when the case at bar arose.

In both of these cases it was held that the reserve balance of the failing member bank should be applied in payment of checks. Both cases concerned receivers of national banks acting under the control of the Comptroller of the Currency. In neither case were appeals taken, and these decisions were left to stand as the only available statement of the law for a period of several years.

We submit that the acquiescence of the Comptroller of the Currency in the decisions mentioned above amount practically to an executive construction of the act upon which the Federal Reserve Bank was entitled to rely and which should not be reversed unless clearly erroneous.

In the case at bar it appears that the Federal Reserve Bank and the holders whose checks were in the letter of October 7th had every reason to believe that they had received final and irrevocable payment for their checks, and that the Receiver appears to have at first assumed that the charge of this letter was proper (Record, page 15), and not until six months after the suspension was there any intimation that any question would be made of the propriety of charging this letter of October 7th, in accordance with the rule laid down in the only decided cases upon the subject (Record, page 21). Obviously the reversal of a long ac-

cepted interpretation will work great hardship on the holders of the checks in the letter of October 7, 1929.

ARGUMENT ON PETITIONER'S POINT B.

Counsel for petitioner under this head contend that the collection of checks by Federal Reserve banks is not dependent upon the reserve balances of member banks.

It is of course true that the two are not inseparably connected. It would have been possible to create central banks authorized to act as reserve depositories only, and it would have been possible to create central clearing agencies to act as intermediaries in the clearing and collection of checks, but we have endeavored to show that the combination of the two functions was suggested by past banking experience and the exercise of one function was a great aid to the convenient performance of the other.

Counsel for petitioner seem to consider that the primary purpose of requiring the maintenance of a reserve is to accumulate a fund to be used in lending to member banks. It is true that the consolidation of the reserves of all banks in a single reserve system permits this use, but the primary purpose of requiring the maintenance of a reserve is to enable a bank to meet demands made upon it by its depositors promptly and effectively. These demands are usually made by checks. Checks are presented in one of three ways:

(a) By the holder at the counter of the drawee bank.

(b) By other banks in the same place, usually through a local clearing house.

(c) By banks in other places, almost always through the mails.

The volume of checks presented in the first way is normally small and perhaps the majority of checks so presented are presented by other depositors of the drawee bank who merely desire credit, so that only a small amount of currency is used in these counter transactions. Checks presented in

the second way are to a large extent set off against checks on the other banks in the town held by the paying bank. The chief use of a balance in a reserve depository is to meet promptly checks presented in the third way.

Since Federal Reserve banks are required to receive at par checks on all of their member banks, the majority of checks on member banks which circulate outside of the place in which the member bank is situated are presented through Federal Reserve banks. Therefore, a system under which the balance in the hands of the Federal Reserve bank can be used to pay checks presented through the Federal Reserve bank by the simple process of charging and crediting affords a simple and expeditious way of clearing such checks and one under which the member bank can use its reserve with greatest convenience for the purpose for which it is primarily intended and the holders of the checks can obtain the benefits of a safe and expeditious method of collection.

Counsel for petitioner state that the exercise of clearing house functions by Federal Reserve banks was permissive but not mandatory. We believe that they have failed to give due consideration to all of the provisions of the Federal Reserve Act. Federal Reserve banks are by the Act required to receive checks on member banks. Section 16 of the Federal Reserve Act (38 Stat. 265, 12 U. S. C. 360), reads in part as follows:

> "Every Federal Reserve Bank shall receive on deposit at par from member banks or from other Federal Reserve Banks checks and drafts drawn upon any of its depositors."

This court recognized in its decision in *Farmers and Merchants Bank of Monroe* v. *Federal Reserve Bank*, 262 U. S. 649, 43 Sup. Ct. 651, 67 L. Ed. 825, that this language was mandatory and distinguished it from language authorizing the receipt of checks upon non-member banks.

If checks upon member banks are received by Federal Reserve banks, some method of collecting them must be ar-

ranged. Such a method might be arranged by the Federal Reserve bank by agreement with its member banks, but it would not be improbable that disagreements might arise with respect to such arrangements, and the Federal Reserve Board was therefore authorized to regulate the clearing functions of Federal Reserve banks.

By Section 19 of the Federal Reserve Act, 12 U. S. C. 464, quoted by counsel for petitioner, reserve balances of member banks are subject to withdrawal under regulations prescribed by the Federal Reserve Board. The Federal Reserve Board, exercising the powers mentioned above, issued Regulation J prescribing a plan for the clearing and collection of checks, providing among other things: "That any Federal Reserve Bank may reserve the right in its check collection circular to charge such items to the reserve or clearing account of any such bank at any time when in a particular case the Federal Reserve Bank deems it necessary to do so."

The Federal Reserve Bank of Richmond, availing itself of this provision of the Regulation, reserved the right to charge the reserve balance. The Lake City bank knew that this right had been reserved and received the checks with this knowledge. Every depositing bank knew that the right had been reserved. Hence we submit that while the method adopted may not be the only method which might lawfully be adopted, it was the method to which all parties to this transaction assented and by which they must of necessity be bound.

In the second sub-division under this point petitioner contends that the authority of the Federal Reserve Bank to withdraw funds from the account of the Lake City account was revoked by the suspension of the latter. This argument appears to be founded upon the assumption that the Federal Reserve Bank was an agent of the Lake City bank. The circular and regulation declare that the Federal Reserve Bank acts as agent for the depositing banks. Its duty was to collect these checks from the Lake City bank. Its relation to the Lake City bank was that of a collecting agent to a

debtor, which is certainly inconsistent with the position of an agent for a debtor.

The liability of the Lake City bank arose from no act done by the Federal Reserve bank but entirely from acts done by the Lake City bank in its own behalf and right and before its suspension, when it had full power to dispose of its assets in any lawful manner.

Before suspension the Lake City bank received these checks upon the condition that they should be charged against its reserve balance if not returned. The checks were cancelled and charged to the drawers by the Lake City bank. Thereby its obligation to pay these checks in the manner agreed upon became absolute and irrevocable. At the time of the suspension not one act remained to be done by the Lake City bank to complete this part of the transaction and to dedicate its reserve balance to the payment of these checks. All that remained to be done was the posting of the books of the Federal Reserve Bank and the entries on the books of the Federal Reserve Bank were delayed only because of the physical necessities of the case.

Counsel for petitioner lay some stress upon the fact that the Lake City bank could establish a balance sufficient to cover its liability for the checks in any one of several ways. This of course was true; but so far as the balance in the hands of the Federal Reserve Bank would avail, the Lake City bank had already provided available funds, and no further action in this respect was necessary or possible. The balance in the hands of the Federal Reserve Bank was at the moment of suspension available for the payment of liabilities of the Lake City bank and the latter had positively agreed that the amount of checks cancelled by it could be charged against this balance.

That the right of the parties in such a case depends upon the actions done by the failing bank and not upon the state of the books, or even the knowledge of the collecting bank, was held by this court in *McDonald* v. *Chemical National Bank*, 174 U. S. 610. In that case the Capitol National Bank of Lincoln, Nebraska, was indebted to the Chemical National

Bank of New York, which indebtedness appears to have arisen in part from checks sent to the former by the latter. Before closing its doors the Capitol National Bank made certain remittances to the Chemical and directed other correspondents to transfer funds to it. These remittances and transfers were neither received nor credited by the Chemical before the suspension of the Capitol National Bank. This court held nevertheless that the right of the Chemical National Bank to hold these funds was complete because all acts necessary to perfect this right were done by the Capitol National before suspension and the posting of the books of the Chemical was not necessary to perfect its right.

ARGUMENT ON PETITIONER'S POINT C.

This section of petitioner's brief is confined to the proposition that the decision of the Circuit Court of Appeals is inconsistent with the principles of law enunciated by this court in *Equitable Trust Company* v. *First National Bank*, 275 U. S. 359, 48 Sup. Ct. 167. The Circuit Court of Appeals discussed the above decision fully and pointed out that the facts bore no analogy to the facts of the present case. A statement of the facts in that case is the best method of distinguishing it.

Knauth, Nachod and Kuhne were bankers apparently dealing in foreign exchange and had a contract with the First National Bank of Denver whereby the latter might draw drafts on banks in foreign countries and the former would arrange for the payment of such drafts on presentation. In pursuance of the agreement First National Bank of Denver drew a check or draft on Banca Commerciale Italiana and requested Knauth, Nachod and Kuhne to protect the same. They requested Banca Commerciale Italiana to honor the draft for their account. Banca Commerciale Italiana upon receipt of the request from Knauth, Nachod and Kuhne charged the amount to their account and credited it to a general account called "Drafts Payable." It appeared that these latter entries were solely for the convenience in ac-

counting between Knauth, Nachod and Kuhne and Banca Commerciale Italiana and that First National Bank of Denver did not know how or from what funds payment would be made, relying solely upon their agreement with Knauth, Nachod and Kuhne, and depending on them to procure payment of the check or draft. It also appeared that in previous similar cases Banca Commerciale Italiana had frequently cancelled such entries and transferred funds from "Drafts Payable" back to the general account of Knauth, Nachod and Kuhne, acting solely upon the directions of the latter.

Before the check or draft above mentioned was presented Knauth, Nachod and Kuhne were adjudged bankrupts. The Equitable Trust Company was appointed trustee of their estate. First National Bank of Denver, having, as drawer of the draft, been compelled to pay the amount to the holder, claimed that the transaction above amounted to an equitable assignment of or the creation of a trust in the funds held by Banca Commerciale Italiana to the credit of Knauth, Nachod and Kuhne. The majority of this court held that there was no equitable assignment and that no trust was created. As the division in this court indicates, it is always difficult to determine equities of a third person under a contract to which he is not a party but from which he may expect some incidental benefit. Perhaps no single test may be applied to all cases, but knowledge of the contract on the part of the equitable claimant is generally essential. The claimant can seldom contend successfully that he has an equitable claim arising from a contract of which he was ignorant.

In analyzing the opinion of Mr. Justice Holmes, counsel for petitioner pointed out that the decision in the case under discussion was based upon three essential elements. It appears to us that none of these elements are present in the case at bar, but, indeed, the agreement of the parties in the case at bar is in its essential features exactly opposite in its effect to the agreement of the parties in the Trinidad case.

The first essential element mentioned by counsel for petitioner is:

(1) The ignorance of the whole affair on the part of the holder.

In the case at bar every holder of a check sent to the Lake City bank was charged with knowledge that it would be handled in accordance with the terms set forth in the circular, one of which was the right to charge the amount of the check against the reserve balance of the Lake City bank if it were not returned.

The second element mentioned by counsel for petitioner is:

(2) The general understanding that the account was subject to the bankrupt's control.

As we endeavored to point out above, the reserve account of the Lake City bank could not have been described as subject to its control at the time of its suspension without ignoring the plain terms of the circular, for it seems evident that if the Lake City bank had demanded payment of its balance just before suspension the Federal Reserve Bank might and should have refused payment upon the ground that it had the right to apply the balance in payment of the checks.

The third element discussed by the petitioner is in substance that the bankrupt in the Trinidad case had not agreed to appropriate any special funds to the payment of this check, but in the case at bar the Lake City bank had definitely and positively agreed that its reserve balance might be so appropriated. It is true that the exact amount of the reserve balance at any particular time was indeterminate, but we respectfully submit that an agreement that a specified fund or property may be applied in settlement of a debt is not an invalid agreement because the value of the particular fund is not at all times the same.

In discussing the principles laid down above, counsel for petitioner state that if the reserve balance was chargeable with the checks as soon as they were accepted by the Lake

City bank, it would have been the duty of the Federal Reserve Bank to make this charge as soon as it was advised that the checks had been accepted. It may be true that such would have been the duty of the Federal Reserve Bank, subject, of course, to charge against the reserve balance other proper charges which had accrued prior to the acceptance of the checks in the cash letters, but we believe we have shown that under the system adopted the Federal Reserve Bank did charge the reserve balance as soon as the charge could be made in the usual and ordinary course of business, and certainly the right to make a charge is none the less valid because there must of necessity be a certain delay in ascertaining that the right has become fixed.

Under this heading counsel for petitioner point out that many charges and credits were made in the reserve account after the dispatch of the letters of October 7th and 8th and that the balance remaining on the night of October 9th was for the most part created by credits made after the dispatch of these letters.

Since these credits were made after the dispatch and probably in some instances after the reecipt of the letters of October 7th and 8th, the only fair assumption is that the credits represent remittances and transfers made by the Lake City bank in fulfillment of its agreement to place in the hands of the Federal Reserve Bank funds sufficient to meet the checks in the letters. If such be the case, then the decision in *McDonald* v. *Chemical National Bank*, 174 U. S. 610, rules the case at bar, because that case dealt with the situation in which transfers and remittances were made to cover a balance due upon an open account.

Respectfully submitted,

M. G. WALLACE,

Counsel for Federal Reserve Bank of Richmond, Respondent.

APPENDIX.

IN THE UNITED STATES DISTRICT COURT, DISTRICT OF MINNESOTA, FOURTH DIVISION.

Paul C. Keyes, as Receiver of the First National Bank of Clarkfield, Minnesota, Plaintiff,

vs.

Federal Reserve Bank of Minneapolis, a Corporation, Defendant.

This cause came on to be heard at Minneapolis, on the 9th and 11th days of October, 1918, J. N. Johnson, Esq., appearing on behalf of the plaintiff, and A. Ueland, Esq., appearing on behalf of the defendant.

The stipulations and testimony having been taken, and each side having rested, by agreement between Court and Counsel, briefs were furnished to the Court and exchanged between Counsel, and thereafter, on the 21st day of October, 1918, the case was orally argued by Counsel.

And now the Court, having duly considered the same,

It is ADJUDGED, ORDERED and DECREED, That the plaintiff take nothing in this action, and that the defendant has a right to a claim against the Receiver for $462.06, which it may file in the Receivership proceedings, and that defendant have judgment for its costs and disbursements, to be taxed by the clerk.

By the Court,

PAGE MORRIS, *Judge.*

MEMORANDUM.

At all times mentioned herein the First National Bank of Clarkfield, Minnesota, was a national banking association duly incorporated under and pursuant to the banking laws of the United States, and up to the 18th of September, 1917, conducted business as a national bank at Clarkfield, Minnesota.

At all times mentioned herein the defendant was a corporation duly organized and existing under and pursuant to an act of Congress of the United States entitled "Federal Reserve Act," approved December 23rd, 1913, and conducting the business of a Federal Reserve Bank at Minneapolis, Minnesota.

The plaintiff's insolvent, First National Bank of Clarkfield, Minnesota, was on the 18th day of September, 1917, insolvent, and was on that day closed by order of the Comptroller of the Currency under and by virtue of the power and authority conferred upon him by the banking laws of the United States, and by virtue of the same power and authority the plaintiff was appointed the Receiver thereof and on the 4th day of October, 1917, duly qualified as such Receiver. Said First National Bank of Clarkfield was a member bank of the defendant under the provisions of the Federal Reserve Act. Pursuant to the provisions of the Federal Reserve Act the Federal Reserve Board, in the month of June, 1916, established a collection and clearing system by rules and regulations which have since been in force and effect, and prior to the transactions herein involved the defendant had become a part of such collection and clearing system, under such rules and regulations. The rules and regulations of the Federal Reserve Board provide, under the heading "Check Clearing and Collecting," as follows (Exhibit "C"):

Each Federal Reserve Bank shall exercise the functions of a clearing house under the following general terms and conditions:

(1) Each Federal Reserve Bank will receive at par from its member banks and from non-member banks in its district which have become clearing members checks drawn on all member and clearing member banks and on all other non-member banks which agree to remit at par through the Federal Reserve Bank of their district.

(2) Each Federal Reserve bank will receive at par from other Federal Reserve Banks and will receive at par from all member and clearing member banks, regardless of their location, for the credit of their accounts with their respective Federal Reserve Banks, checks drawn upon all member and clearing member banks of its district and upon all other non-member banks of its district whose checks can be collected at par by the Federal Reserve Bank. The Federal Reserve Banks will prepare a par list of all non-member banks to be revised from time to time, which will be furnished to member and clearing member banks.

(3) Immediate credit entry upon receipt subject to final payment will be made for all such items upon the books of the Federal Reserve Bank at full face value, but the proceeds will not be counted as part of the minimum reserve nor become available to meet checks drawn until actually collected, in accordance with the best practice now prevailing.

(4) Checks received by a Federal Reserve Bank on its member or clearing member banks will be forwarded direct to such banks and will not be charged to their accounts until sufficient time has elapsed within which to receive advice of payment.

(5) In the selection of collecting agents for handling checks on non-member banks, which have not become clearing members, member banks will be given the preference.

(6) Under this plan each Federal Reserve Bank will receive at par from its member and clearing member banks

checks on all member and clearing member banks and on all other non-member banks whose checks can be collected at par by any Federal Reserve Bank. Member and clearing member banks will be required by the Federal Reserve Board to provide funds to cover at par all checks received from or for the account of their Federal Reserve Banks. *Provided, however,* that a member or clearing member bank may ship currency or specie from its own vaults at the expense of its Federal Reserve Bank to cover any deficiency which may arise because of and only in the case of inability to provide items to offset checks received from or for the account of its Federal Reserve Bank.

(7) Section 19 of the Federal Reserve Act provides that—

The required balance carried by a member bank with a Federal Reserve Bank may, under the regulations and subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: *Provided, however,* that no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored.

It is manifest that items in process of collection can not lawfully be counted as part of the minimum reserve balance to be carried by a member bank with its Federal Reserve Bank. Therefore, should a member bank draw against such items the draft would be charged against its reserve balance if such balance were sufficient in amount to pay it; but any resulting impairment of reserve balances would be subject to all the penalties provided by the Act.

In as much as it is essential that the law in respect to the maintenance by member banks of the required minimum reserve balance shall be strictly complied with, the Federal Reserve Board, under authority vested in it by section 19 of the Act, hereby prescribes as the penalty for any deficiency in reserves a sum equivalent to an interest charge on the amount of the deficiency of 2 per cent per annum

above the ninety-day discount rate of the Federal Reserve Bank of the district in which the member bank is located. The Board reserves the right to increase this penalty whenever conditions require it.

For the purpose of keeping their reserve balances intact member banks may at all times have recourse to the rediscount facilities offered by their respective Federal Reserve Banks.

(8) Each Federal Reserve Bank will determine by analysis the amounts of uncollected funds appearing on its books to the credit of each member bank. Such analysis will show the true status of the reserve held by the Federal Reserve Bank for each member bank and will enable it to apply the penalty for impairment of reserve.

A schedule of the time required within which to collect checks will be furnished to each bank to enable it to determine the time at which any item sent to its Federal Reserve Bank will be counted as reserve and become available to meet any checks drawn.

(9) In handling items for member and clearing member banks, a Federal Reserve Bank will act as agent only. The Board will require that each member and clearing member bank authorize its Federal Reserve Bank to send checks for collection to banks on which checks are drawn, and, except for negligence, such Federal Reserve Bank will assume no liability. Any further requirements that the Board may deem necessary will be set forth by the Federal Reserve Banks in their letters of instruction to their member and clearing member banks. Each Federal Reserve Bank will also promulgate rules and regulations governing the details of its operations as a clearing house, such rules and regulations to be binding upon all member and non-member banks which are clearing through the Federal Reserve Bank.

And the rules and regulations governing the details of its operations as a clearing house promulgated by defendant provide, under the heading "Check Clearing and Collecting," as follows (Exhibit "B"):

1. The Federal Reserve Bank of Minneapolis will discontinue its present collection system on July 15, 1916, in accordance with Federal Reserve Board Circular 1, Series of 1916, already sent you, and will thereafter, until further notice, receive from its member banks for immediate credit at par, checks drawn on all member banks in the United States and on such non-member banks as can be collected at par.

A par list of all non-member banks will be prepared, to be revised from time to time, which will be furnished member banks.

All such checks, except those drawn on Minneapolis and St. Paul banks, received by the Federal Reserve Bank by 3:00 P. M., except Saturday, when the hour will be 12:00 o'clock noon, will be credited subject to final payment at full face value upon day of receipt. Those received later than these hours will be credited upon the following business day. *The proceeds, however, will not be counted as reserve, nor become available to meet checks drawn, until actually collected.* Owing to the clearing house, checks drawn on Minneapolis and St. Paul banks received after 10:30 A. M., will not be credited nor proceeds become available until the following business day; those received before that hour will be credited on day of receipt and proceeds will be available that day.

3. Checks received by the Federal Reserve Bank, drawn on its member banks, will be forwarded direct to such member banks, and *will be charged to their accounts on the date which, under usual conditions, advice of payment may be expected.* Member banks should *credit* all remittances received from the Federal Reserve Bank upon day of receipt, advising the Federal Reserve Bank, and should not remit their drafts in payment. *Member banks are required by the Federal Reserve Board to provide funds to cover at par all checks received from, or for the account of, their Federal Reserve Bank.*

Section 19 of the Federal Reserve Act provides that:

"The reserve carried by a member bank with a Federal Reserve Bank may, under the regulations, subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: Provided, however, *that no bank shall at any time make new loans or shall pay any dividends unless and until the total reserve required by law is fully restored.*"

7. In handling items for member banks, the Federal Reserve Bank of Minneapolis acts as agent only. It is understood that each member bank authorizes it to send checks for collection direct to banks on which checks are drawn, and except for negligence the Federal Reserve Bank of Minneapolis assumes no liability until funds are actually in its hands.

In September, 1917, there was and still is at Clarkfield, Minnesota, where the First National Bank of Clarkfield was located and doing business, a bank organized under the laws of Minnesota called the Clarkfield State Bank; and during all of said month this bank was a non-member bank of defendant upon which defendant could collect checks at par; and said bank was on the par list of non-member banks perpared by defendant and furnished to its member banks in accordance with said rules and regulations.

On the 17th of September, 1917, checks payable on presenstation amounting to $1,998.21 were deposited with defendant. These checks to the amount of $1,943.96 were on said Clarkfield State Bank and to the amount of $54.25 on said First National Bank of Clarkfield. These checks to the amount of $548.49 were so deposited by the Northwestern National Bank of Minneapolis, Minnesota, a member bank of defendant; and to the amount of $555.21 by the Merchants National Bank of St. Paul, Minnesota, a member bank of defendant; and to the amount of $218.30 by the Peoples Bank of St. Paul, Minnesota, a member bank of defendant; and

one check for $570.86 by the First National Bank of Chicago, Illinois, a national banking association, and as such a member of the Federal Reserve Bank; and one check for $5.35 by the Corn Exchange National Bank of Chicago, Illinois, a national banking association, and as such a member of the Federal Reserve Bank; and one check for $100 by the Des Moines National Bank of Des Moines, Iowa, a national banking association, and as such a member of the Federal Reserve Bank. Each check when deposited with defendant contained on the back thereof the unrestricted and unconditional endorsements in blank of the payee thereof and of the bank depositing the same with defendant and credit was on that day given by defendant at par to the bank depositing the same.

After said checks were deposited with defendant and credit given for them as aforesaid, and on said 17th day of September, 1917, defendant forwarded all said checks by mail to said First National Bank of Clarkfield, for payment and credit as to the checks for $54.25 on said bank, and for collection and credit as to the checks for $1,943.96 on the Clarkfield State Bank, and all said checks were received by said First National Bank of Clarkfield on the 18th of September, 1917.

On said 18th of September, 1917, the First National Bank of Clarkfield cleared with said Clarkfield State Bank checks which each then held against the other, and in this clearing the First National Bank of Clarkfield used all the checks on the State Bank of Clarkfield received from defendant as aforesaid and received credit for the same from said Clarkfield State Bank, but received no money. In said clearing the First National Bank of Clarkfield surrendered and delivered to the Clarkfield State Bank as fully paid and cancelled, all the checks on the latter bank which it had received from defendant, and the First National Bank of Clarkfield thereupon and on said 18th of September, 1917, and before it was closed or a receiver appointed for it, gave defendant credit on its books for all the checks which it received from defendant on that day as aforesaid, to-wit, for the sum of $1,998.21.

The checks for $54.25 on the First National Bank of Clarkfield were returned by said bank or the plaintiff to the various drawers thereof, and the checks for $1,943.96 on the Clarkfield State Bank were returned by it to the various drawers thereof, by reason whereof a more particular description of any of said checks can not be given.

No remittance or payment was ever made to defendant or any of the payee or endorsers of any of the above mentioned checks for or on account of such checks, or for or on account of the credit which defendant received on the books of said First National Bank of Clarkfield for said checks.

Thereafter, and on the 16th of October, 1917, defendant charged back severally to the various banks which had deposited the checks aforesaid, amounting to $1,998.21, the amount of said checks which had been so deposited by each of said banks. And thereafter, and on the 14th day of May, 1918, this action was brought.

On the 18th day of September, 1917, the First National Bank of Clarkfield had a balance to its credit on the books of defendant of $8,647.04. On the 25th of January, 1918, upon an accounting between plaintiff and defendant it was found that said bank was entitled to a credit for the amount of its stock in defendant with dividends accrued thereon to September 1, 1917, of $963, and to a further credit for unearned discounts on notes due March 1, 1918, of $21.90, making in all $9,631.94, and that defendant had a right to deduct therefrom the amount of certain forged notes (the forgery having been discovered after the closing of the bank for insolvency), with interest, which had been discounted by said bank with defendant prior to the 18th of September, 1917, for the purpose of replenishing the reserve of said bank with defendant and the proceeds of which forged notes constituted a part of said balance of $8,647.04. After making these credits and deductions a balance of $1,536.15 was found to be due from defendant to said bank unless defendant has the right to set off against this balance the amount of the aforesaid checks for $1,998.21.

On said 18th of September, 1917, and for some time prior thereto, said First National Bank of Clarkfield was insolvent and was known by its cashier and one of its directors to be insolvent.

The sole contention and question to be decided here is as to whether or not the defendant is entitled to offset against the aforesaid balance of $1,536.15, the amount of the aforesaid checks, $1,998.21, the plaintiff contending that it has not the right to do so and the defendant that it has.

Under the pleadings and proofs here whether the offset be legal or equitable in its nature the right to its allowance can be determined in this action U. S. Comp. Statutes, Sec. 1251-b (Judicial Code 247-b, as amended by Act of March, 1915, Ch. 90, 38 U. S. Statutes at large, 956).

That defendant handled said checks as a clearing house, for the purpose of collection and clearing, and for no other purpose, is mutually conceded by counsel. Considering the matter then as a clearing house transaction it seems to me clear that, if the First National Bank of Clarkfield and the Clarkfield State Bank had been banks doing business in Minneapolis and the clearing had been had there on the 18th of September, 1917, upon finding that the $1,998.21 was due from the First National Bank of Clarkfield to defendant, the defendant would have had the right to immediate payment thereof to it by that bank either in money or by check on its balance with defendant, or to charge said amount to said bank's account and have said bank give it credit thereof, and that being done the transaction would have been completely closed. But the defendant was the clearing house for banks in a wide territory, embracing the whole State of Minnesota, and was the clearing house for these two Clarkfield banks, and these checks had to be forwarded by mail and the clearance had at Clarkfield. Is it not apparent that upon the clearance being had between the Clarkfield banks defendant had the right to a credit with the First National Bank of Clarkfield for this amount and to charge the same to the account of said bank? That credit was given, but the charge was not made. It seems to me

that defendant then had a right of action against that bank for said amount in its own name and in its own right. And if this is true, it is clear it has had that right ever since, and therefore has the right of set off. The Receiver, the plaintiff here, took the assets of the bank as a mere trustee for creditors, and not for value and without notice, and, in the absence of statute to the contrary, subject to all claims and defences that might have been interposed as against the insolvent bank. The subsequent charging back of the checks by defendant or the subsequent statements of counsel for the defendant in his letters would not in any way affect the conclusion. The recovery of the set off here will fully protect the plaintiff and he has no interest in, and is not concerned to inquire into, what was done between defendant and the banks depositing these checks or what advice has been given to defendant by its counsel. *Elmquist* v. *Markot,* 45 Minn. 305; *Vanstrum* v. *Liljengren,* 37 Minn. 191.

But let us consider the matter not as a clearing house transaction but as one of an agency for collection. The whole argument of plaintiff's counsel rests upon the proposition that as at the time the suit was brought the defendant was not the owner of the checks, they having, on the 16th of October, 1917, been charged back to the banks which had deposited them with defendant for collection, defendant has now no right of set off. He also quotes from letters written by defendant's counsel subsequent to the closing of the bank which he contends supports his proposition, and he claims that these letters and the charging back of the checks work an estoppel against the defendant's now asserting the right of set off. It does not seem to me that these statements of counsel and the charging back of the checks in any way effect the rights of the parties here. As to the claim of estoppel it may be said that the most essential element of an estoppel is absent. In the charging back of the checks and the statements of counsel for defendant there has been no act, representation or concealment upon which plaintiff or his insolvent has been induced to act, nor has there been any action by plaintiff or his insolvent in reliance

thereon of a character to result in substantial prejudice to him or to his insolvent or to the creditors for whom as receiver he is trustee of the assets of the insolvent. It seems to me that the rights of the parties became fixed as of the time of the closing of the bank. *Scott* v. *Armstrong*, 146 U. S. 499-511. At that time defendant had a right of action against plaintiff's insolvent for the amount of the checks, whether or not they were only received by it as an agent for collection and conditional credit, and whether or not the endorsements thereon were restricted or uninrestricted. General Statutes of Minnesota 1913, Section 5848 and 5849. The subsequent ownership of the checks is unimportant. There was no defense as to the checks and no defense as to the credit arising therefrom on the books of the insolvent bank. The plaintiff has no standing to inquire into the relations between defendant and its depositing banks. Neither the insolvent nor its receiver has any concern with the question of the ownership of the checks, unless a defense be shown as against the endorsers or drawers thereof, or that defendant became the holder thereof after the closing of the bank for insolvency, or after knowledge of its insolvency. There is no such showing, and on the contrary the opposite appears. *Farmers Deposit National Bank* v. *Penn. Bank*, 123 Pa. 283; *Penn. Bank* v. *Farmers Deposit National Bank*, 130 Pa. 209.

Plaintiff's counsel contends that the allowance of the offset would work a preference contrary to the provisions of sections 5234, 5236 and 5242, Revised Statutes of the U. S. 1878 (the National Banking Act). This contention is, I think, fully disposed of adversely thereto by the decision of the Supreme Court in the case of *Scott* v. *Armstrong, supra.*

I am therefore of the opinion that defendant is legally entitled to the set off in question. And if I am in error as to that, I still think that under all the facts and circumstances of this case it is equitably entitled thereto. *Scott* v. *Armstrong, supra.* It must be remembered that the insolvent bank and its creditors received the full benefit of the amount of the checks. If the doctrine of estoppel can be

invoked at all here, it would be to prevent the receiver from objecting to the set off, at least to the amount of $1,943.96, the amount of the checks drawn on the State Bank of Clarkfield. Plaintiff's insolvent was, on the 18th of September, 1917, and for some time prior thereto, insolvent, and known to be so by its chief managing officer. Notwithstanding that fact it held itself out to be solvent, and received and handled these checks as above set forth. Relying on its solvency and induced by its holding itself out to be so, defendant forwarded these checks to it when it might have forwarded them direct to the State Bank of Clarkfield, which of course was to be substantial prejudice of defendant.

The result is, that the balance of $1,536.15 is wiped out, and defendant has the right to a claim against the receiver for the difference between that amount and $1,998.21, the amount of the checks, to-wit, $462.06.

PAGE MORRIS, *Judge.*

(ENDORSED)

Filed Novr. 25, 1918.
Charles L. Spencer, Clerk,
By Thomas H. Howard, Deputy.